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State and Local Government Fiscal Position in 1979

THE State and local government surplus on a national income and product accounting (NIPA) basis was $24.4 billion in 1979, down $3 billion from the surplus in 1978. The decline was the result of a deceleration in the growth of receipts; at 7 percent, growth was the lowest since 1954. A deceleration in spending growth limited the decline in the surplus.

The decline in the surplus reflected a $3½ billion increase in the surplus of social insurance funds and a swing of $6½ billion from surplus to deficit in other funds. This swing resulted mainly from tax reductions that became law in 1978 and 1979. The largest of these was the reduction in local government property taxes under California's Proposition 13; numerous other changes involved personal income and general sales taxes. Taxpayers' concern about the effects of inflation on them was probably the prime motive for these reductions. The vote for Proposition 13 reflected taxpayers' concern that inflation-generated increases in property values were precursors of rising property taxes. Several States introduced indexing techniques intended to sever the relationship between inflation in incomes and increasing effective tax rates on these incomes.

Receipts

State and local government receipts increased 7 percent in 1979, compared with 11 percent in 1978 and 11½ percent in 1977 (table 1). Deceleration occured in all major receipts categories except corporate profits tax accruals, which increased 15 percent in both 1978 and 1979.

Growth of general own-source receipts—that is, personal tax and nontax receipts, corporate profits tax accruals, and indirect business tax and nontax accruals—decelerated, as it had also in the 2 preceding years (chart 10). Law changes were responsible for the deceleration in 1978; slower personal income growth and a decline in gasoline usage were responsible in 1979.

Personal tax and nontax receipts increased 9 percent, down from 13 percent in 1978. Income taxes, their largest component, increased only 6½ percent, down from 15 percent. Income tax law changes in 1979, coupled with the effects of 1978 legislation (especially in California and New York), reduced personal tax growth by 3½ percentage points in 1979 and 1½ points in 1978.

Most of the income tax law changes involved more than simple rate reductions. A number included indexation in some form. Arguments for indexation, which is more widely used abroad than in the United States, start from the observation that, given a progressive income tax structure, increases in dollar incomes give rise to increased effective tax rates. As a result, the proportion of total income retained by taxpayers declines, and the proportion received by government as tax revenue increases. If inflation is the source of the dollar increase in income, taxpayers suffer a loss of real income. Proponents of indexation argue that such a redistribution of real income should be the result of conscious legislative decision, rather than the unintended effects of the tax structure.

Under indexation, any or all three of the determinants of tax liability that are stated in dollar amounts—personal exemptions and deductions as well as tax rate brackets—are adjusted, i.e., indexed, to reflect changes in the price level. For example, in Arizona, each year the value of personal exemptions

Table 1.—State and Local Government Receipts, NIPA Basis

	Calendar years								
	Billions of dollars					Percent change			
	1975	1976	1977	1978	1979 ᵖ	1976	1977	1978	1979 ᵖ
Receipts	238.9	266.0	296.8	331.0	354.4	11.1	11.6	10.8	7.1
General own-source receipts	166.9	187.2	207.7	226.6	243.8	12.0	11.0	9.1	7.6
Personal tax and nontax receipts	43.4	49.0	56.8	64.1	69.9	14.0	15.8	12.9	9.1
Income taxes	22.8	26.6	30.9	35.5	37.9	17.2	16.6	14.9	6.5
Nontaxes	14.9	16.4	18.4	20.8	23.7	13.0	12.6	12.9	14.0
Other	6.1	6.8	7.4	7.8	8.3	9.8	10.2	4.7	7.0
Corporate profits tax accruals	7.1	9.3	10.9	12.5	14.3	31.0	17.4	14.9	15.0
Indirect business tax and nontax accruals	116.4	129.0	140.0	150.0	159.5	11.0	8.4	7.1	6.3
Sales taxes	51.5	57.8	63.0	71.3	78.1	12.1	10.0	11.6	9.6
Property taxes	52.8	57.9	62.4	63.2	63.9	9.6	7.0	1.3	1.2
Other	11.1	12.3	13.7	15.5	17.5	11.3	11.0	12.7	12.6
Contributions for social insurance	19.4	19.7	23.4	27.1	30.5	20.4	19.0	14.8	12.6
Federal grants-in-aid	54.0	61.1	67.6	77.3	80.1	11.0	10.5	14.0	3.6
Addenda: Receipts, excluding selected law changes:									
Total	236.3	266.0	297.8	334.3	362.8	13.0	11.6	12.2	8.6
General own-source receipts	165.2	186.1	206.7	226.0	252.3	13.0	11.1	11.2	8.8

ᵖ Preliminary.

NOTE.—Estimates of the effects of law changes are not comprehensive, either in coverage or type of tax. They represent major law changes identified for personal income, sales, and business property taxes.

and of the standard deduction is increased by the amount of the increase in the Consumer Price Index for the Phoenix metropolitan area. Specific deductions, such as for property taxes, are not indexed because they move of their own accord with an increase in the price level. Of the 41 States imposing income taxes on wages and salaries, none had indexation in 1977. In 1978, California, Colorado, and Arizona began indexing. Iowa and Minnesota began in 1979, and Wisconsin in 1980. Oregon will begin in 1981. Several other States will consider indexing systems during this year's legislative sessions.

A new technique was introduced in 1979 for dealing with a problem created by tax changes legislated after the beginning of the tax year. The problem is that of matching liabilities and withholding. If withholding is reduced to levels appropriate for liability for the entire year, and those levels are introduced after the beginning of the year, there are larger refunds (or smaller final settlements) than if liability had not been changed. Net government revenues may be reduced sufficiently to cause cash-flow problems in the months when settlements occur. If, to prevent this, withholding is set to put the entire year's reduction in liability into the part of the year remaining after the tax cut, withholding must be raised at the beginning of the next year, giving the appearance of a tax increase. The new technique is designed to avoid both difficulties. It sets withholding at the rate appropriate for the new liability, and puts that rate into effect only for as many months as required for withholding to approximate liabilities; withholding is suspended for a period between the end of old withholding rates and the beginning of the new ones. The first State to use this technique was Wisconsin. It suspended withholding for two months after passage of a tax reduction measure. Later, Montana suspended withholding for one month after an increase in the value of exemptions; Kansas took a similar action. The technique had popular appeal because, during the suspension of withholding, taxpayer disposable income was higher.

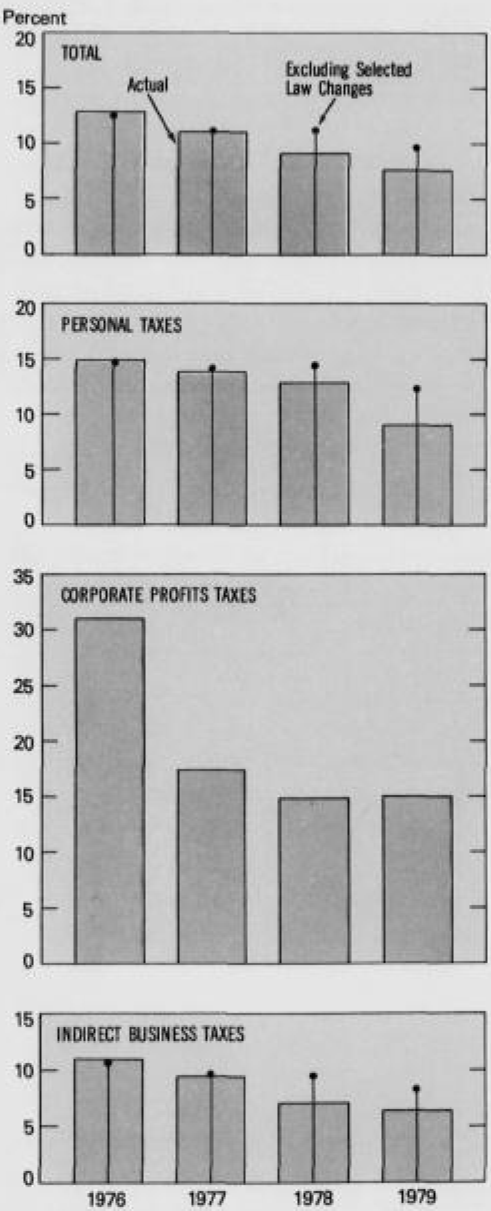
Personal nontaxes—chiefly tuition and hospital charges—increased 14 percent in 1979, a little more than in 1978. The step-up was largely the result of new and/or increased charges imposed in California after passage of Proposition 13. (See "Proposition 13: One Year Later" in the October 1979 issue of the SURVEY OF CURRENT BUSINESS.)

Indirect business tax and nontax accruals increased 6½ percent, a little less than in 1978. A decline in highway gasoline consumption accounted for most of the deceleration. Sales taxes, which in recent years have become the largest component of indirect business taxes, increased almost 10 percent in 1979, compared with 11½ percent in 1978. The effect of law changes on the sales tax total for 1979 was only $0.1 billion, but there were larger offsetting changes in many components. The largest legislated increases in 1979 were in gasoline taxes. In virtually all States, these revenues are dedicated to the construction, maintenance, and operation of highways. A combination of slow revenue growth—partly due to shortages of gasoline, but more importantly to the increasing proportion of more fuel-efficient vehicles in the total stock—and increasing costs of highway construction and maintenance forced many highway departments to defer maintenance or cut back construction. Legislatures in a number of States responded with gasoline tax increases. Offsetting these law changes were reductions in general sales taxes, which, with one minor exception, involved changes in the tax base, rather than rates. West Virginia began a removal of grocery food sales from the tax base. Five States removed residential purchases of some utility services or heating fuel, and others partly or totally removed business equipment. Of the 45 States imposing general sales taxes, more than one-half now exempt grocery food sales, and some of those that impose such a tax allow special income tax credits or deductions for taxes paid on food sales.

Property tax growth decelerated in 1977 and 1978—in 1978, largely due to California's Proposition 13. The absence of further deceleration in 1979, when the increase was again less than 1½ percent, suggests that Proposition 13 was not widely imitated outside California, at least with respect to property taxes. Measures of similar intent have been imposed on local governments in States other than California, but apparently none has as yet had a major effect on overall property tax growth. One local jurisdiction, Prince Georges County in Maryland, imposed a unique zero-growth limitation on property tax collections for the county, so that addi-

CHART 10

State and Local Government General Own-Source Receipts: Percent Change From Preceding Year



U.S. Department of Commerce, Bureau of Economic Analysis 80-1-10

Table 2.—State and Local Government Expenditures, NIPA Basis

	Calendar years								
	Billions of dollars					Percent change			
	1975	1976	1977	1978	1979 p	1976	1977	1978	1979 p
Expenditures	**230.6**	**250.1**	**271.9**	**303.6**	**329.9**	**8.4**	**8.8**	**11.6**	**8.7**
Purchases of goods and services	215.4	231.6	251.8	283.0	309.8	7.5	8.7	12.4	9.5
Compensation of employees	119.6	131.2	143.7	157.8	171.4	9.6	9.6	9.8	8.6
Structures	34.7	32.3	31.1	37.6	40.0	−6.9	−3.5	21.0	6.3
Medical vendor payments	12.4	14.2	15.5	17.2	19.2	14.0	9.6	10.8	11.8
Other purchases	48.6	54.0	61.4	70.4	79.2	11.0	13.7	14.6	12.5
Transfer payments to persons	24.5	27.4	30.2	33.3	36.3	11.6	10.2	10.5	8.8
Benefits from social insurance funds	9.6	11.1	12.8	14.4	16.5	15.0	15.4	13.0	14.4
Direct relief	11.9	12.8	13.5	13.6	14.0	7.8	4.9	1.3	2.5
Other	3.0	3.5	3.9	5.2	5.8	15.8	13.0	33.5	10.0
Net interest paid	−4.8	−4.1	−4.9	−7.1	−9.5				
Interest paid	11.0	12.5	13.9	15.0	15.9	13.4	8.5	7.6	6.2
Less: Interest received by government	15.8	16.6	18.9	22.1	25.5	5.1	14.1	16.6	15.4
Subsidies less current surplus of government enterprises	−4.5	−4.8	−5.0	−5.5	−6.7				
Subsidies	.2	.2	.2	.2	.3	19.6	11.1	13.8	37.7
Less: Current surplus of government enterprises	4.7	5.0	5.3	5.7	7.0	7.9	4.8	9.0	22.7
Less: Wage accruals less disbursements	0	0	0	.2	−.1				

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tions to taxable property will reduce tax liability for all other property. Limitations of this severity apparently have not been imposed elsewhere.

Federal grants-in-aid contributed strongly to the deceleration in total receipts. They increased only 3½ percent, down from 15 percent in 1978. Grants for local public works were down about $2 billion, from $3 billion in 1978, as funds appropriated in 1976 and 1977 were used up. Other grants for capital purposes increased about $2 billion. Grants in support of current spending—employment and training, welfare, food and health programs, etc.—increased about 4½ percent, down from 13 percent in 1978.

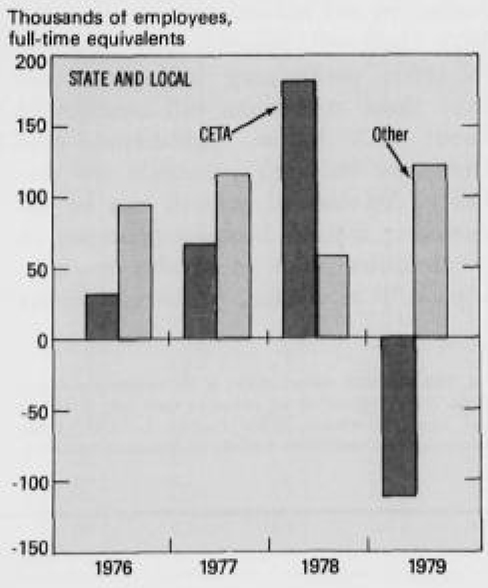
Expenditures

Expenditures increased 8½ percent in 1979, well below the 11½ percent increase recorded in 1978 but about the same as in 1977 (table 2). The 1979 deceleration was largely in purchases of goods and services, and affected all major categories of purchases except medical vendor payments. The total of expenditures other than purchases declined slightly in 1979.

Purchases, by far the largest component of expenditures, increased 9½ percent, compared with 12½ percent in 1978. Compensation of employees, more than one-half of total purchases, increased only 8½ percent, after increasing 9½–10 percent in each of the previous 3 years. Shifts in the funding of State-local government employment through the Federal Comprehensive Employment and Training Act (CETA) have had a major effect on the pattern of changes in employment (chart 11). CETA was responsible for 25–35 percent of employment growth for States and localities in 1976 and 1977, and about 75 percent in 1978. In 1979,

CHART 11

State and Local Government Employment: Change From Preceding Year



U.S. Department of Commerce, Bureau of Economic Analysis

CETA employment declined by more than 100,000 while total State and local employment remained almost unchanged.

After six years of experience with CETA programs, there remain unanswered questions about the extent to which CETA employees in local governments replace regular employees that would have been employed in the absence of the CETA program, and about pay differentials between CETA and regular employees. It is not possible to determine the extent to which the employment shift in 1979 represented a direct movement of former CETA employees into regular positions. However, on the assumption that this movement did occur to a substantial degree, it is possible to draw some tentative conclusions about average pay for the "new" regulars. Average pay for non-CETA employees registered annual increases of about 8 percent in 1977–79, while CETA average pay registered little change. Given the 8½-percent increase in 1979 total compensation, and virtually no change in total employment, it is evident that average pay for the "new" regular employees exceeded that of the workers who left CETA rolls in 1979.

Purchases of structures increased only 6 percent in 1979, down from 21 percent in 1978. This sharp deceleration was partly the result of a 13-percent weather-related decline in the first quarter. Inflation raised construction costs about 12 percent in 1979, so the volume of construction declined about 6 percent. The largest increases were in public housing; airports, port facilities, recreation areas, and similar facilities; electric utilities; and transit facilities. Increases in highways, schools, and other types of construction probably were exceeded by cost increases, so that the volume of these types of construction declined. Purchases of other goods and services from business (including medical vendor payments) increased about 12 percent, a slight deceleration from 14 percent in 1978. Higher prices accounted for most of the 1979 increase; volume increased only about 2 percent.

Transfer payments increased 9 percent, compared with 10½ percent in 1978. Social insurance fund transfers increased 14½ percent, about the average for the 3 previous years. Welfare (direct relief) transfers again increased less than 3 percent, after increases of 5 and 8 percent, respectively, in 1977 and 1976. Stricter administrative controls and, in some States, postponement of cost-of-living increases contributed to this deceleration. Other transfers increased only 10 percent. The 33-percent increase in 1978 for this category was mainly due to State-local transfers to nonprofit institutions for CETA training programs and for nonprofit CETA employment. In the NIPA's, nonprofit institutions are part of the personal sector, and payments to these institutions are treated as transfer payments.

The rate of increase in interest paid decelerated slightly for the third consecutive year. Municipal interest rates increased, although less than rates affecting most other borrowers, and new borrowing was lower. Interest received continued to increase more rapidly than interest paid. The strong increase in the current surplus of enterprises reflected revenue increases, primarily for liquor stores and certain utilities, such as water and electricity supply.

Fiscal position

With social insurance funds excluded, State and local governments were in deficit in 1979, for the first year since 1975. However, this move into deficit should not, of itself, be regarded as an indicator of serious financial difficulty for these governments. This other-funds measure has typically registered a deficit; prior to 1972, when general revenue sharing funds accounted for much of the surplus, the last surplus was recorded in 1947. Because capital spending by governments is combined with current spending in the summary NIPA presentations, and because much of the capital spending by States and localities is funded by long-term borrowing, the "normal" fiscal position of the other-funds measure has been a deficit.[1] The strong 1978 acceleration of capital spending, and continued—if slower—growth in 1979, thus help to explain the move into deficit.

From another point of view, the 1979 move into deficit can be seen as representing a "spending down" of surpluses accumulated in 1976–78. Spending down took the form of financing tax reductions rather than financing increased expenditures. For example, the Proposition 13 property tax reduction was funded in part by spending assets accumulated over several years in the general fund of the State of California. Restoration of the estimated tax reductions in both 1978 and 1979, in the absence of other changes, would have raised the 1978 other-funds surplus to $7.5 billion, and the 1979 deficit to a $6.1 billion surplus.

Outlook

In 1980, total receipts will increase more rapidly than the 7 percent registered in 1979, but—in the absence of major new Federal initiatives involving strong growth in grants—will not reach 10 percent. If a recession materializes, it will limit increases in own-source revenues—chiefly taxes. This effect would be largest at the State level, because sales and income taxes, which are the primary State revenues, are responsive to changes in the economy. Income tax growth will continue to be curbed by tax reductions passed during 1979 that will become fully effective in 1980; preliminary indications are that these reductions will amount to about $1.5 billion. Additional cuts from new indexing proposals are also likely. Accelerated growth can be expected in indirect business nontaxes, as oil decontrol adds to royalty receipts, expecially in Alaska, California, Texas and Louisiana. For localities, increases in property taxes will be slowed by the effect of actions taken in late 1978 in Alabama, Idaho, and Texas, which should begin to be noticeable during 1980. However, growth will be in the 5–7 percent range—compared with 1 percent in 1979 and 1978—because the effect of Proposition 13 is now fully incorporated in current property tax levels.

Expenditures growth will probably remain around 9 percent. Purchases of goods and services from business other than structures will continue to increase slightly faster than prices. Because borrowing costs will remain high, net new borrowing for capital purposes should decline again in 1980. As a result, the increase in spending for structures is likely to be small. Total compensation is likely to increase in the range of 7–8 percent. The increase in compensation will be in large part a function of: (1) further reduction in CETA employment (2) the extent to which these lost positions will be replaced by regular positions and the extent to which former CETA employees enter them, and (3) the average pay levels for any replacement positions. With respect to the first point, in the absence of new Federal initiatives, CETA government employment in 1980 will be about 50,000 lower than in 1979. With respect to the second point, the extent to which States and localities will absorb former CETA employees into the regular work force is uncertain. However, preliminary data indicate that total State-local employment did not decline in the fourth quarter of 1979 despite a reduction in CETA employment; this suggests that substantial numbers who left CETA entered regular State-local employment. It is probable that some additional absorption will occur in 1980.

Overall, the State and local governments other-funds measure will probably remain in deficit, but that deficit will probably be only slightly larger than the one registered in 1979.

1. This and other characteristics of the surplus and deficit in the NIPA framework are discussed more fully in "State and Local Government Fiscal Position in 1978," in the December 1978 issue of the SURVEY OF CURRENT BUSINESS.